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Regions Financial Corp. (RF)

Q3 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Regions Financial Corporation's Quarterly Earnings Call. My name is Shelby, and I'll be your operator for today's call. I would like to remind everyone that all participant phone lines have been placed on listen-only. At the end of the call, there will be a question-and-answer session. [Operator Instructions]

I will now turn the call over to Dana Nolan to begin.

Dana W. Nolan

Executive Vice President & Head-Investor Relations, Regions Financial Corp.

Thank you, Shelby. Welcome to Regions' third quarter 2019 earnings conference call. John Turner will provide highlights of our financial performance; and David Turner will take you through an overview of the quarter. Earnings-related documents, including forward-looking statements, are available under the Investor Relations section of our website. These disclosures cover our presentation materials, prepared comments, as well as the Q&A segment of today's call.

With that, I will now turn the call over to John.

John M. Turner, Jr.

President, Chief Executive Officer & Director, Regions Financial Corp.

Thank you, Dana; and thank you, all, for joining our call today. This morning, we reported earnings from continuing operations of $385 million, a 9% increase over the third quarter of last year, resulting in earnings per share of $0.39, an increase of 22% over the prior year. This quarter, we also delivered the highest pre-tax, pre-provision income that we've produced in nearly a decade, while generating 3% adjusted positive operating leverage year-to-date. All in all, despite lower interest rates and significant market volatility, it was a very solid quarter.

Over the last two years, our core messaging has reflected our intention to generate consistent and sustainable long-term performance through all phases of the economic cycle. We've been planning for the time when we would no longer benefit from a rising rate environment and when credit would begin to normalize.

Since late 2017, we began taking incremental actions to reduce our interest rate risk, build a stronger and more resilient balance sheet and improve returns on capital. We executed a robust hedging strategy that will protect us in a declining rate environment and allows us to maintain a healthy and stable margin without having to stretch for loan growth.

With respect to credit, our team has spent the better part of the last 10 years fundamentally changing and improving our credit risk management framework. Today, we have a robust and dynamic process, centered on appropriate concentration risk, sound underwriting, rigorous client servicing and early identification of potential problems. We've also intensified our focus on risk-adjusted returns and appropriate capital allocation, balance sheet optimization, de-risking and repositioning.

Just as important, we launched our continuous improvement initiative called, Simplify and Grow, focusing on our desire to make banking easier for our customers and associates, accelerating revenue growth, and driving efficiency and effectiveness. We've already benefited significantly from these efforts, and we have much more to do. We have completed 16 of 67 initiatives and expect to complete 7 more by year end. These efforts have allowed us to make significant investments in technology to better serve our customers, and we're seeing the benefits of those investments.

For example, through our digital platform, year-to-date checking and credit card production have increased 24% and 91%, respectively. Loan applications have increased 55%. And with mortgage in particular, approximately 60% of all applications are completed online. Mobile deposits have increased 60% and now represent 13% of all deposits. These efforts are paying off and possibly impacting the performance of our businesses. Simplify and Grow has allowed us to make investments in talent, improve services and capabilities and in our markets, all while prudently managing our expense base. And these investments are also paying off.

We continue to grow consumer checking accounts and households, as well as wealth assets under management. We're also succeeding in our priority growth markets: Atlanta; Houston; Orlando; and St. Louis. Consumer deposits and checking accounts in these markets are growing more than 2 times faster than the consumer bank average. Similarly, corporate bank revenue and loans are growing faster than the corporate bank average. Although it's relatively early, we're very pleased with the performance of these markets, as we are delivering results above our expectations.

With respect to the economy, our customers are still generally optimistic about their businesses, but they're becoming more cautious, given continued market volatility and uncertainty regarding trade and tariffs. Many are taking a wait-and-see approach when it comes to business investments. However, pipelines remain steady, good but not great.

So, in summary, we have a lot of positive momentum and feel good about how we're positioned. Our plan is to remain focused on the things we can control: Meeting the needs of our customers with best-in-class service, while leveraging technology and making it easier for our customers to bank with us. We're also focused on the fundamentals of our business, generating positive operating leverage through disciplined expense management, while making prudent investment decisions. We're focused on soundness, profitability and growth, in that order of priority. We believe our efforts will keep the company positioned to deliver consistent, sustainable results through every economic cycle.

Thank you for your time and attention this morning. I'll now turn the call over to David.

David J. Turner, Jr.

Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

Thank you, John. Let's start with the balance sheet. Adjusted average total loans decreased approximately 1%. Adjusted average consumer loans increased modestly, led by residential mortgage and indirect other consumer lending. Adjusted average business loans decreased 1% and were impacted by our continued focus on client selectivity and overall relationship profitability. Average business loans also reflected lower line utilization and elevated pay-down activity during the quarter, including increased capital markets activities.

We continue to focus on risk-adjusted returns and are not interested in pursuing nominal loan growth for short-term benefit. And as John noted, due in part to our hedging program, we were not pressured to stretch for growth. With that said, we continue to expect full-year adjusted average loan growth in the low to mid-single digits.

Turning to average deposits. Despite interest rate decreases on deposits and seasonal declines in public fund accounts, average deposits decreased less than 1% during the quarter, exhibiting the strength of our deposit franchise.

So, let's look at how this impacted net interest income and margin. Despite lower rates, net interest income was down just slightly compared to the second quarter. And net interest margin declined only 1 basis point to 3.44%. Net interest margin and net interest income were negatively impacted by lower market interest rates and lower average loan balances, partially offset by declining deposit costs and the benefits of repositioning strategies in the investment portfolio that were executed in the second quarter. Net interest income also benefited from one additional day in the quarter, which negatively impacted net interest margin.

As expected, total deposit costs declined 4 basis points compared to the second quarter to 49 basis points. And interest-bearing deposit costs declined 5 basis points to 77 basis points, one of the lowest in the industry. The deposit beta associated with declining interest rates was 25% this quarter. And we expect to experience a deposit beta in the 25% to 30% range in the fourth quarter.

In an effort to reduce net interest income sensitivity to long-term rates, we repositioned out of approximately $1.2 billion of mortgage-backed securities into pre-payment protected securities this quarter. These reallocations reduced our exposure to mortgage-backed securities by approximately 7% and our related book premium by approximately 8%. We're also exploring additional opportunities to further reduce sensitivity to long-term rates. In fact, we added additional hedges subsequent to quarter end that are intended to reduce the impact of lower long-term rates on 2020 loan originations.

Assuming two 25-basis-point reductions in the Fed Funds rate by year end, we expect some near-term pressure on net interest income and net interest margin in the fourth quarter, which we can partially mitigate through reductions in deposit costs. Net interest margin is expected to move in the high-3.30s in the fourth quarter. However, we expect the first quarter margin to expand into the low-3.40s as the benefits of our hedging strategy begin.

Now, let's take a look at fee revenue and expenses. We delivered strong results this quarter with adjusted non-interest income increasing 9% compared to the second quarter, led by growth in service charges, wealth management, and mortgage, as well as favorable market value adjustments on employee benefit assets. The increase in wealth management income includes a modest benefit from the recent acquisition of an institutional investment firm, Highland Associates.

Total mortgage income increased significantly, driven primarily by increasing hedging and valuation adjustments on residential mortgage servicing rights. Additionally, mortgage production and sales income also increased, consistent with elevated production, highlighting the benefit of our strategic focus and our decision to add mortgage loan originators earlier in the year. Partially offsetting these increases were declines in capital markets income and card and ATM fees.

The decline in capital markets income was attributable primarily to decreases in M&A advisory services and loan syndication revenue. Customer swap income was also negatively impacted by CVA adjustments during the quarter. Looking ahead, we expect capital markets to finish this year on a strong note, with fourth quarter revenue exceeding this quarter's reported results. The decline in card and ATM fees reflected the impact of favorable commercial interchange rebate adjustments recorded in the prior quarter that did not repeat. We continue to expect full-year adjusted revenue growth of approximately 2%.

Let's move on to non-interest expense. Adjusted non-interest expense increased less than 1% compared to the prior quarter, driven primarily by higher salaries and benefits, partially offset by decreases in professional fees and outside services. The increase in salaries and benefits was driven primarily by an increase in the market value on employee benefit assets, as well as higher production-based incentives, one additional weekday in the quarter and the addition of Highland Associates. These increases were partially offset by continued overall staffing reductions. The decreases in professional fees and outside services were primarily due to lower legal costs and our continued success in reducing overall third-party spend. The company's third quarter adjusted efficiency ratio decreased 90 basis points to 57.4%, and the effective tax rate was approximately 20.6%.

As John mentioned, we continue to benefit from our continuous improvement process. And several Simplify and Grow initiatives are exceeding our initial expectations. For example, at Investor Day, we committed to reducing our total square footage by 2.1 million square feet and our third-party spend by $60 million to $65 million by 2021.

We also told you we plan to consolidate 100 branches during the same period. We are proud to say that we are on track to exceed our targets in each of these areas and will continue to look for opportunities to pull forward or expand on initiatives where we can. These efforts exhibit our commitment to achieving positive operating leverage. Based on our results through the first nine months and our expectations for the fourth quarter, we expect full-year 2019 adjusted expenses to be relatively stable with 2018. With respect to our effective tax rate, we've tightened the full-year 2019 range to 20% to 21%.

So, let's shift to asset quality. Overall, credit results remained in line with our risk expectations during the quarter. We saw improvement in several categories, while experiencing some normalization in others. Net charge-offs were unchanged at 44 basis points, in line with our expected range of 40 to 50 basis points for 2019.

The allowance for loan losses amounted to 1.05% of total loans and 188% of total non-accrual loans. Non-performing loans decreased 13%, while delinquencies and total troubled debt restructured loans decreased 4% and 7%, respectively. Business services criticized loans increased 9%, driven primarily by increases in classified loans, partially offset by reductions in non-accrual and special mention loans. The largest increases to classified loans were attributable to energy, retail trade and manufacturing sectors. As a reminder, our third quarter credit metrics also include the results of the most recently completed Shared National Credit Exam.

Provision exceeded net charge-offs during the quarter, primarily due to these downgrades, as we've begun to see some stress within the energy and tariff-related sectors. However, potential losses associated with these credits are expected to be modest and within our expectations. Moreover, we anticipate several will [ph] occur in full (00:15:18) over the next few quarters.

Let me comment briefly on CECL. In our second quarter 10-Q, we disclosed an expected increase on our allowance for credit losses of approximately $400 million to $600 million due to the implementation of CECL. As we get closer to adoption, we expect subsequent disclosures to include a tighter range of impact and will reflect evolving macroeconomic conditions and forecast, as well as any appropriate updates to loan composition and quality.

So, let's take a look at capital and liquidity. During the quarter, the company repurchased 39.7 million shares of common stock for $589 million and declared $150 million in dividends. Our common equity Tier 1 ratio was estimated at 9.6%, in line with our target level of 9.5%. And we anticipate managing at this approximate level going forward. The loan/deposit ratio at the end of the third quarter was 88%. And as of quarter-end, we remain fully compliant with the Liquidity Coverage Ratio rule.

Wrapping things up, in light of the challenging and changing economic backdrop, we are pleased with our third quarter financial results. We have a solid strategic plan designed to deliver consistent and sustainable performance throughout any economic cycle.

With that, we're happy to take your questions, but do ask that each caller ask only one question to allow for more callers. We'll open the line for your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. The floor is now open for questions. [Operator Instructions] Your first question comes from Ryan Nash of Goldman Sachs.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Morning, Ryan.

Ryan M. Nash
Analyst, Goldman Sachs & Co. LLC
Q

Hey. Good morning, guys. How's it going?

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Good.

Ryan M. Nash
Analyst, Goldman Sachs & Co. LLC
Q

So, I wanted to ask a handful of questions. Maybe just, first, on deposit costs. So, we saw them come down nicely on the high end of peers, 25% to 30% decline next quarter. I just wanted to double check to make sure that's based on September and the potential for an October.

And I guess, you're one of the only banks we saw top quartile performance on the way up, and now, you're outperforming on the way down. So, can you maybe just talk about what you're seeing across both consumer and commercial? And if the Fed is to cut in October or beyond a couple times next year, is there further room to bring down deposit costs?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Yeah, Ryan. This is David. So, we've talked an awful lot about how to manage net interest income and margin in changing rate environments, and deposit costs being a key input. It's important to manage both. So, I'm going to start with consumer. We've done a really good job of adjusting our deposit costs, while staying competitive in the markets that we are competing in, and that's been a big driver of our deposit cost declining.

I think what you'll see going forward is probably more contribution coming from the commercial side. We've done a pretty good job, a lot of those deposits are indexed. If you recall, in the first quarter, we increased deposit cost, because we had above average loan growth that we had to use deposits to fund that loan growth. That's clearly subsided, and we're looking at adjusting those deposit costs on the way down. So, we have a beta of 25% to 30% that we are giving you guidance for. And we think that'll apply to potential rate cuts that we see for the remainder of the year.

Ryan M. Nash
Analyst, Goldman Sachs & Co. LLC
Q

Got it. And then, if I could follow up on expenses. I mean, clearly, the revenue environment has been challenging. You guys are doing a better job than others to defend the margin. David, you talked about completing 16 of 67 initiatives for Simplify and Grow, and you're going have a handful more done before the end of the year, when you talked about upside, some of the areas that – the three big areas that you're saving on cost. So, as you think ahead, you're clearly holding costs stable this year, but are there enough levers for you to continue to invest in things, like technology and grow the business, and continue to hold expenses flat beyond 2019? Thanks.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

So, I won't comment quite on 2020 yet, but the way we think about it is, we are continuing to make investments in talent, mortgage loan originators, commercial RMs, wealth advisors. We've continued to make investments in technology. 42% of our $625 million is spent on new things that we need to have to continue to make banking easier for our customers. We have to do that, and we will continue to do that. But in order to make room for that control cost, we have to get better at literally everything we do.

So, John has asked all of us, all 20,000 people that work here, how do we get better at whatever we do tomorrow than we did yesterday, so that we can continue to make room for investments that we want to make? We have inflation in our expense base of about 2.5%. So, we have to overcome that inflation plus the investments to be able to hold our cost relatively stable, like we've done for the last couple of years.

We will continue to hold our cost down. And we have a goal of efficiency, to get to the 55% range. We've mentioned that at Investor Day. We're 57.4% today. I would say, it's very challenging in a low-rate environment, but we are not giving up. We're going to continue to seek becoming more efficient as we go forward. So, there's still room to control cost into 2020.

Ryan M. Nash
Analyst, Goldman Sachs & Co. LLC
Q

Got it. Thanks for taking my questions.

Operator: Your next question comes from Matt O'Connor of Deutsche Bank.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Morning, Matt.

Matthew Derek O'Connor
Analyst, Deutsche Bank Securities, Inc.
Q

Hi, guys. I was wondering if you could just talk about kind of big picture how you think about balancing – protecting the profitability ratios versus growing the balance sheet. You've been keeping deposits relatively stable and it's helping them. You're obviously seeing good growth in service charges, so there's some puts and takes.

But talk about the trade-off between the focus to protect the profitability, but then also thinking about trying to grow the balance sheet.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Yeah. I think it is a great question. It is very much a balance. We're focused on building a business that's going to be consistently performing, that's going to be resilient, that's going to be sustainable. And that means we've got to build a balance sheet that is resilient through every economic cycle. We've clearly traded off some growth for quality. And we'll continue to do that, Matt, as we focus on – we think it's a period of time in the economic cycle where we need to be thoughtful, careful. Client selectivity is really important to us, early identification of problems, exiting relationships that may become problematic, really important to our future.

So, we talk often about the importance of soundness first, then profitability, and growth last. We are not going to grow just to grow. We don't need nominal growth. We think the balance sheet is positioned to deliver consistent and sustainable performance and the profitability that we believe will adequately reward our shareholders. And that'll continue to be our focus.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. And I'll add, Matt, that we do expect to grow. As we said, we would grow low to mid-single digits in terms of loans for the year. We were up about 4.8% year-to-date on an adjusted basis, and so what we're saying is we do expect to grow. We're just not going to force growth on the balance sheet to generate nominal revenue and nominal income if the return gets hard.

Matthew Derek O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

And, I guess, just following up, I mean, you obviously had really nice loan growth in the first half of the year, a little bit of runoff this quarter. And I think one of your other portfolios might start to run off by the end of the year. And just, if you kind of put it all together in the comments that you made, what's kind of the more medium-term outlook in terms of being able to grow loans? And also, just comment on deposits as well. Thank you.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Yeah. Well, with respect to loan growth, I think, what we've said is that we anticipate growing low-single digits, typically with the economy [indiscernible] (00:24:21) in markets that we operate in. We think that, that's appropriate. If you look at year-over-year, business services loan growth has been about 7.5%. We do have some runoff portfolios in consumer, in particular. We've seen some declines in equity lending and indirect auto. We're capping our exposure to indirect unsecured lending. But we believe that our focus on continuing to build out the consumer business, at the same time, our commitment to business services lending, particularly middle market commercial lending will drive an appropriate amount of loan growth and allow us to continue to grow the assets side of the balance sheet.

And with respect to deposits, we're focused on core relationships. When you look at our consumer business, we believe that 93-plus percent of our customers maintain their primary operating account with us. We're continuing to grow consumer checking accounts at a rate, we think, faster than most of our peers. Consumer demand deposits and consumer low-cost deposits, growing over time. Similarly, with a focus on small to medium-size businesses, winning their operating business, we think, we can still continue to grow low-cost deposits, which is really the core of our business and the strength of our franchise.

Matthew Derek O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. That's helpful. Thank you.

Operator: Your next question comes from Ken Usdin of Jefferies.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning, Ken.

Ken Usdin
Analyst, Jefferies LLC

Q

Good morning, guys. David, can you talk a little bit about the balance sheet protection a little bit more? Just reading in the deck that you added a little bit more on the hedging side to impact – impact of lower long-term rates. So, you said the program's largely completed, I guess, can you just help us understand the math of – the magnitude of the step up that helps get the NIM up as you look from fourth to first, and then how that will cascade on its own throughout the year? Thanks.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. So, I'll start, Ken, with the end in mind. We talked about the – going into next year, we think our margin could increase into the low to mid-3.40% range. We have a chart with regards to our sensitivity. Our short-term sensitivity is, take it, close to zero by the beginning of the year through all the hedges that kick-in and starting little bit in the fourth quarter, but primarily in the first part of the year.

What we want to do is we have more exposure on the long end than a lot of our peers, so we want to kind of neutralize that a bit. So, we've entered into a couple billion dollars' worth of hedges that would really be – that kind of get tied in when the 10-year was in the mid to low-1.70% range to help us from the long end. And that really manifest itself in reinvestment of cash flows that come off the business every month. So, that's baked into the guidance that we're giving you. And we believe that we're not going to have a disproportionate correlation to the 10-year relative to our peers after this.

Ken Usdin
Analyst, Jefferies LLC

Q

Okay. Got it. And on the left side of the balance sheet, can you just discuss the MBS repositioning that you did, and what premium am was, and how does this change that magnitude that you'd expect? Thanks, David.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. So, premium amortization was relatively stable in the quarter, about $28 million in the quarter. What we did is we took some low-yielding investment securities that we could sell. We took those, we repositioned those into longer, little more duration, little more carry, to help us just again boost a little bit from an NII standpoint. But they were really lower-yielding mortgage-backed securities that we sold and reinvested.

Ken Usdin
Analyst, Jefferies LLC

Q

Thanks a lot, David.

Operator: Your next question comes from Betsy Graseck of Morgan Stanley.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning, Betsy.

Betsy L. Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Good morning. Okay. So, couple questions. The background for the question just has to do with the longer-term outlook for RoTCE, which I know you put out at – I think, it was like 15% to 18%, is that right, at the Investor Day? And...

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Actually, 18% to 20%. Yeah [indiscernible] (00:29:00)

Betsy L. Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Sorry, 18% to 20%. Yeah, 18% to 20%, sorry.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

A little different interest environment.

Betsy L. Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Yeah, exactly. So, the question that I have is how are you thinking about that? When I'm looking at it, I'm hearing, okay, you've got a lot more opportunity on the expense side, and maybe that expense – operating leverage improves as we go through the next couple of years. But then, I'm also wondering about the capital side of the equation here, and how you're thinking about that. I know you have your 9.5% target, but given the tailoring rule that came out and everything else that's been happening for banks in your size, is 9.5% still the right number for you?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. So, I'll start with your last question. Yeah, we calculate the amount of capital we need to have based on our model. It's not regulatorily driven. And yes, we're encouraged by the tailoring relief that we have, but does not change one iota or the amount of rigor that we've put into capital planning and management. We still have, every other year, a CCAR submission.

So, for the time being, 9.5% was our target. We tried to put that in our prepared comments, too. Even though our math really says, we could get to 9%, we've added 50 basis points of cushion to enable us to take advantage of opportunities, should they arise as the market uncertainty and the economic conditions continue to decline a bit. As it relates – and the 9.5% was going to allow us to get to the kind of returns we think are appropriate given the circumstances that we're under.

Now, the 18% to 20% was, as John was saying in the middle of your question, that we had – that was a very different interest rate environment. We all thought rates were going to go up this year, and they clearly are down, and they're forecast to be down through the period of time we have covered by the Investor Day. So, getting to 18% to 20% would be very difficult to do without taking some unusual risk which we will not do.

So, we're going to come out, and we'll update the exact targets for you later. But clearly, there's been some decline in terms of return expectations. I think that's what the stock prices in our industry have reflected. But exactly where those will be, we need to get a little better handle on where we think rates will go. We have two baked in for this year, there's probably another one coming in 2020 as well. So, more to come, Betsy.

Betsy L. Graseck
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Thank you.

Operator: Your next question comes from John Pancari of Evercore ISI.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning, John.

John Pancari
Analyst, Evercore Group LLC

Q

Good morning. I want to see if you could talk a little bit more on the investments you're making in IT? I believe you're currently evaluating replacing your core deposit system. And so, I want to see if you can give us some details around that in terms of what's the timeframe around that type of project? What's the cost impact that we should be considering here? Could it impact next year's numbers? And then, is there other systems – are you looking at the core system on the loan side as well, or just the deposit system issue? Thank you.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

And so, John, it's great question. We just had our strategic planning offsite meeting with the board, spent a lot of time talking about the topic. And so, I ask John Owen to address it.

John B. Owen
Chief Operating Officer & Senior Executive Vice President, Regions Financial Corp.

A

Yeah. Just to go back to Investor Day, we spend about $625 million a year on technology and about 1,600-plus technology professionals at the bank. And every year, at our strategic annual planning process, we go through about a three to five-year view and find out and really talk about what systems need to be upgraded, consolidated or replaced. And each year, there's about 15 systems that we identify that will need to go out and either upgrade or replace. So, this is just a normal case of business, normal course of business today.

You mentioned some of the core systems around deposits. We are going to have an RFP that will go out in the first quarter for our deposit system. We'll get those results back probably midyear, and we'll make a choice on what's the right platform for us. The timeframe for that is probably a three to six-year journey for this. What you'll find with us when we do upgrade, we don't do very many big-bang upgrades. This will be an incremental approach over a multi-year time period. So, again, this is a probably a four to six-year system exchange in this particular case.

I would tell you, we do about 15 of these a year. This would be a larger one, of course. But again, if you go back to our Wealth platform, we did SEI a couple years ago. We consolidated 14 systems into one. We're fortunate to operate on one consumer platform. And we're in the point of implementing [indiscernible] (00:33:58) at this point in time. So, what I would tell you, it is large. We are in the RFP process, but this is nothing that we don't do – 15 to 17, every year.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

And our analysis, John, will indicate that we can complete the work within the context of our current technology spend. So, we don't see any outsized sort of allocation to expense associated with any of the core system changes.

John Pancari
Analyst, Evercore Group LLC
Q

Okay. Thank you. That's helpful. And then, one – I apologize, this is a little bit off the radar, a little bit, this question. But on Friday, you issued an 8-K that you announced that you're expanding your change-in-control provisions to an additional component of the management team beyond the C-suite executives. Can you give us just a little bit of color on what that relates to, and how common is it that you're modifying the change in control?

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Yeah. Thank you for the question. I guess, we really did two things, both were intended to standardize. You can imagine, with the truest announcement, there's a lot of concern about what our future is, what our intentions are, a lot of questions about what may happen going forward.

It caused us to look at our change-in-control agreements. And because the bank was the combination of a lot of banks over a long period of time, what we quickly concluded was we had a fair amount of inconsistency in our agreements, both with respect to change in control and severance. And we asked our board to consider a change in the – or modifications to both change in control and severance to make them more consistent, so they apply to both an appropriate group, and they applied similarly to that group. And so, it simply was a housecleaning sort of an initiative for us, to get everything in order. No real significant change for our shareholders, or frankly, for our associates, but it does create some consistency.

John Pancari
Analyst, Evercore Group LLC
Q

Got it. That's helpful. Thank you.

Operator: Your next question comes from Erika Najarian of Bank of America.

Erika Najarian
Analyst, Bank of America Merrill Lynch

Q

Hi. Good morning.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning, Erika. Good morning.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Good morning.

Erika Najarian
Analyst, Bank of America Merrill Lynch

Q

Given your outlook for a continued low to mid-single digit loan growth , and clearly, you laid out a very specific path for net interest margin, is it too optimistic to think that net interest income could be flat next year?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Well, we don't want to give guidance yet on what next year is. We can still have things that we don't know about, what the rate environment look like. Clearly, that puts pressure on growing net interest income. When you think that – and we've talked a lot about being able to grow the balance sheet consistent with GDP, and then some, then a little. Now, we've also done a lot of capital recycling to make sure that we're getting good relationship business on the books. And so, you've seen some pressure on absolute loan growth there. But we expect to grow, and our teams have that expectation. So, we had that piece of it we feel good about. Let's just see what the rate environment gives us going into next year. Lower rates obviously put some pressure on us.

Erika Najarian
Analyst, Bank of America Merrill Lynch

Q

Got it. And as I think about your earlier responses, clearly, the RoTCE range is potentially out of reach, given the interest rate outlook. But you did say, you're not giving up on 55%. And as we think about the context of revenue challenges and potentially on the – because of rate and fees potentially peaking this year, I guess, is there room for expenses on an absolute basis to actually be down to get to continued efficiency improvements?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Well, so our commitment has been and continues to be generating positive operating leverage in any environment. So, we are seeking to grow revenue faster than the expenses. So, where revenue continues to be challenged, we'll continue to work even harder on expense management. I feel that we can do that.

So, I think that, clearly, revenue is going to be challenged, kind of back to the last part, last question is – revenue will be challenged because 65% of our revenue comes from spread. And we had higher rates in the first half of the year versus the back half. And so, on a comp 2019 to 2020, it will be very hard to grow revenue in that, at least NII. So, loan growth will help us there a bit, and we'll see what the rate environment is.

But, we have good NIR, we have good investments that we've made, we expect that to continue to grow. And as we just talked through, our continuous improvement program by helping control expenses, we believe, will generate positive operating leverage and continue to work our efficiency ratio down at the same time.

Erika Najarian
Analyst, Bank of America Merrill Lynch

Q

Yeah. And I just want to be clear, even in an environment that you mentioned where it's very hard to grow revenue, Regions is still committed to deliver positive operating leverage?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

That's correct.

Erika Najarian
Analyst, Bank of America Merrill Lynch

Q

Thank you. Thank you so much.

Operator: Your next question comes from Saul Martinez of UBS.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning, Saul.

Saul Martinez
Analyst, UBS Securities LLC

Q

Hey. Hi. Good morning, guys. A couple questions. First, more of a clarification. The 25% to 30% deposit beta in the fourth quarter, what's the denominator on that? Is that on two cuts, and hence, it's a 12 to 15-basis-point reduction in deposit costs? It's not – I'm just trying to make sure it's not on an average Fed Funds rate, because obviously, out of July and September cut, that's fully in the fourth quarter. I just want to make sure I understand the numerator and denominator there.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. So, it's based on two rate cuts that are baked in October and December right now.

Saul Martinez
Analyst, UBS Securities LLC

Q

Okay. So, it would be a 12 to 15-basis-point reduction?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Round number, that's right.

Saul Martinez
Analyst, UBS Securities LLC

Q

Okay. Got it. I guess, more important question on loan growth. I hear what you're saying that over the long run – or under normal conditions, you can grow your balance sheet in line with what – and hopefully then some. But if I look at your loan growth this quarter, period end, it was up, I think, 1% year-on-year. Going forward, you have indirect vehicles rolling off, tune maybe a few hundred a quarter. You have GreenSky as a headwind. Home equity, still a little bit of a headwind. Your CRE book isn't really growing. It's contracting, I think, on mortgage owner-occupied. I mean, I'm struggling with how you get loan growth and interest-earning asset growth next year.

Can you just – hope we understand where you see the offset, where – I know you're not giving guidance for 2020, but how do I think about it conceptually, given you have pretty material headwinds in multiple loan lines?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

So, there's a lot of stories inside the loan book. Let's kind of start at the top. So, our big driver of loan growth has traditionally been our C&I book. Those can be lumpy from time to time. It depends on access to capital markets. It depends on line utilization, and you've seen some of that happening this year. I mean, it's – we had a lot of growth in the first quarter and no growth in the second and the third quarter. We feel good about our pipelines. We feel good about our conversations we're having with our clients. They are cautious. They're optimistic, but they're watching this uncertainty with regards to trade and tariffs. Clearly put some pressure and downward sentiment in terms of wanting to make the next dollar fixed capital investment. But that being said, we still think there's going to be some growth there.

From an investor real estate standpoint, we've probably had the second lowest concentration of investor real estate of our peers. We have some opportunities there. We're being very careful in selecting these clients. And so from time to time, you'll see that move up, and then payoffs will move it back down. But I think investor real estate is an opportunity. Resi mortgage continues to be an opportunity. We had a little bit of growth this quarter. Production was up. About a third of that was refinance, and two-thirds of it was purchase. And we keep about almost half of what we produce. So I think that'll be a plus in our direct consumer. We think it's going to be a plus. We're making investments in unsecured. Even though GreenSky is running off, we have other avenues. I think John mentioned, we're going to cap unsecured, but we continue to see opportunities for a little bit of growth there.

Now, home equity has been on quite a bit of decline over time, and we think that'll slow down a bit. So, I think that when you – and you had mentioned indirect vehicles being down, those are really the key drivers. Again, we're not looking for a lot of loan growth, but I think we'll have solid loan growth that'll be profitable for the company.

Saul Martinez
Analyst, UBS Securities LLC
Q

The GreenSky is roughly $2 billion, I believe? And how quickly does it – what's the weighted average life of that?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Yeah. It's about $1.9 billion actually. And it has a little – right at two years in terms of duration. There'll be pieces of this that linger for a while, but the bulk of that is two years.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

And, Saul, it begins to run off. We've modestly increased our commitment to SoFi to grow that portfolio. And we are investing in our own unsecured lending capabilities. And we believe that we can match the timing of the runoff and the increase in SoFi with unsecured lending capabilities, all of which should help us on the consumer side in addition to growing mortgage, growing bank card and the growing direct lending.

Saul Martinez
Analyst, UBS Securities LLC

Q

Got it. Thank you very much.

Operator: Your next question comes from Gerard Cassidy of RBC.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Morning, Gerard.

Gerard Cassidy
Analyst, RBC Capital Markets LLC

Q

Good morning. How are you, John?

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good. Thank you.

Gerard Cassidy
Analyst, RBC Capital Markets LLC

Q

Can you guys share with us, we hear – and you guys already touched on your technology spend. I think you had mentioned $625 million is what is expected to be expense this year. How can we, as outsiders – we hear a lot of stories about the big banks taking market share from the smaller banks. How do you guys measure whether you're keeping – I know the dollars you're spending, but how do you measure whether you're keeping up from a digital, technological standpoint that you can remain competitive with the bigger banks? What are some of the metric should we outsiders look to, to determine whether you're keeping up with these bigger banks?

John B. Owen
Chief Operating Officer & Senior Executive Vice President, Regions Financial Corp.

A

Yeah. Just real quick on that, this is John Owen. Like I said earlier, we spend about $625 million. About 42% of that is based on new initiatives and new projects and looking forward into new things, which digital would be a big part of that. About 48% is around how do we maintain the bank, maintain systems and really our infrastructure going forward. About 10% is on cyber risk. The way we think about, are we keeping up and keeping pace, we use a few external factors.

Number one would be J.D. Powers. J.D. Powers (sic) [J.D. Power. J.D. Power] ranks all the – top 23 banks are on their list, and they come out with a quarterly ranking. And they rank everything from how we perform in the branch, all the way through to our online banking and mobile banking. So, that's a data point we use consistently. We're in the top quartile for branch. And online/mobile moves between top quartile and second quartile. So, again, that's an area where we're trying to always keep that in the top quartile. The other source would be Gallup. Gallup also gives us good insights from our customers on how we're performing in digital and areas where we need to advance.

And the other thing I would point to is just the rapid growth of our digital at the bank. Over the last three years, our digital logins to our online and mobile properties were up 90%. You heard John talk about earlier on digital sales. Our digital sales are up 90% year-over-year in credit card. Our digital sales and savings accounts were up 35%, and checking accounts about 24%. So, we kind of look at it from a couple of factors, how do our external parties validate what we're doing and also our internal growth rates.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Yeah. I'll just add, Gerard. The other thing I look at is how we're growing consumer checking accounts. Are we growing low-cost deposits and who are our new customers. And roughly, half of our new customers are under the age of 30. And so, all of those things, for me, are indicators that we are, in fact, competing and having success, offering compelling technology to our customers.

Gerard Cassidy
Analyst, RBC Capital Markets LLC
Q

Very good. And David, you talked a bit about the CECL increase you mentioned, you guys put out the number in the second quarter Q. I think you said, $400 million to $600 million, which if you compare that to your existing level of reserves, it's over a 50% increase. Everybody appears to be able to handle, yourself included, the Day 1 impact that you just described. How can you frame out for us, if you can, what the Day 2 impacts are going to look like? Should we, as outsiders, assume that we're going to see loan loss provisions of similar increases to what the Day 1 impact was for everybody, or how are you guys looking at that at this stage?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Yeah. I would not say that Day 2 would be anything remotely close to Day 1. Day 1 just kind of level sets. And we'll see what other peers are coming out and what their numbers are. Really, it's dependent on portfolios. Those with consumer or longer-dated loans are going to have higher CECL charges than those that are business services oriented that have shorter-term duration of their loan books.

Day 2, you need to think about you still have charge-offs to come through. You have to provide CECL reserves and provisioning on loan growth. Those have the tendency to be somewhat higher than we have today under the incurred model, and again, very dependent on what type of loans you're growing. So, mix makes a big difference. So, if you're growing mortgages versus commercial real estate, mortgages are going to carry a higher provision than commercial real estate as odd as that sounds.

And then, the last key factor is what's the economic outlook? How is that changing from time to time? And that's why we've put in our prepared comments. We've given you $400 million to $600 million, but it's really dependent on what it looks like December 31, last January 1. What do we think the forecast looks like going forward, that makes a big difference. And in Day 2, when that change occurs, things getting better or worse, you see, in particular, when they get worse or forecasted to get worse, you can see much bigger provisions then than you do on the incurred model and that's what the standard was supposed to do.

It was trying to have you reserve much quicker, and that's why we've talked about procyclicality. The standard is as procyclical as you can get because in a down rate cycle, you're going to be reserving more for loan growth, which causes one to be concerned about the cost and availability of credit in a downturn.

Gerard Cassidy
Analyst, RBC Capital Markets LLC
Q

Very good. Thank you.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Thank you.

Operator: Your next question comes from Brian Foran at Autonomous.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Brian, good morning.

Brian D. Foran
Analyst, Autonomous Research US LP
Q

Hi, everyone. I guess I actually had a couple of questions on your slide appendix. First of all, thank you for this level of detail on the commercial loan portfolio or some of the key areas you're highlighting. It is quite a lot. I guess, as I'd looked through slide 14 – really, maybe 15 through 17, because the energy you've talked about before, the restaurant, the retail, the manufacturing, transportation, how are you positioning this? Is this just being responsive to investor questions, or are these areas you're actively concerned? Are there any sub-portfolios where you're seeing opportunity to maybe take some market share? I guess how should I interpret all this detail why you're highlighting restaurant, retail, manufacturing, and transportation?

Barbara I. Godin
Senior Executive Vice President, Deputy Chief Risk Officer and Chief Credit Officer, Regions Financial Corp.
A

Brian, this is Barb Godin. On that note, we do have some concerns in the restaurant portfolio, that we're seeing some softening in the restaurant portfolio. There's certainly been some softening in the energy portfolio, a little bit in manufacturing. But by and large, we decided to be much more transparent, providing you with information on our portfolios, so that all of you have an opportunity to look and say, look, we see what's in their portfolio, we feel good about their portfolio, we feel good about our portfolios and our ability to manage it. And we just felt that now was the time to be, as I said, much more transparent, particularly as we go into what potentially looks like a credit cycle that'll happen in the next couple of years.

Brian D. Foran
Analyst, Autonomous Research US LP
Q

And then, maybe in a similar vein on slide 12, I mean, I almost hate to ask this, but it's always a little bit of a lightning rod for investors, the leverage loan balances. Certainly, recognizing the $6 billion is much bigger number than the standard definition of what would produce $2.5 billion that you highlight in the slides. But I think when you first gave this, it was about $5.5 billion. So, why has it kind of crept up a little bit over the past six to nine months? Is that you participating more, or is that just some credits tripping into your leverage definition? Why has the number gotten a little bigger?

Barbara I. Godin
Senior Executive Vice President, Deputy Chief Risk Officer and Chief Credit Officer, Regions Financial Corp.
A

Yeah. We do have a number of credits, but again based on the way we define it, will become leveraged even though they started off as not leveraged. Additionally, we've got Ronnie Smith here who runs that portfolio, and I'm going to ask him to make a couple of comments on them.

Ronald G. Smith
Senior Executive Vice President & Head of Corporate Banking Group, Regions Financial Corp.

A

Just a couple of comments. And one of your responses is exactly on target. We had a couple of really long-term relationships, publicly-traded companies that had positive credit events that pushed it over into our definition of leverage lending. And if you combine those two, it was just over $400 million. We feel good about those particular companies, and we'll see at least one of those resolved within a very short period of time. The other will resolve, given a little bit more intermediate period of time, but there's not really a focus on growing that portfolio other than continuing to support our existing relationships, where we can build broad and deep relationships outside of the lending transaction only.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

I'd just add we actually have managed it as a concentration risk, like we do every other part of our portfolio.

Brian D. Foran
Analyst, Autonomous Research US LP

Q

That's great, and thank you for all the detail.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Thank you.

Operator: Your next question comes from Christopher Marinac of Janney Montgomery Scott.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning, Christopher.

Christopher Marinac
Analyst, Janney Montgomery Scott LLC

Q

Hey, good morning. Wanted to ask further on the credit explanation you just gave. Should we see a higher level of total criticized than we do now, or will that number kind of vary? I know you had the spec change driving a lot of this quarterly shifts.

Barbara I. Godin
Senior Executive Vice President, Deputy Chief Risk Officer and Chief Credit Officer, Regions Financial Corp.

A

Yeah. It's Barb again. In the criticized portfolio, in particular, classified, I think, is what you're pointing to, which drove that number up. Let me first start with saying, despite all that, our credit metrics for the quarter were within our broader risk expectation. We experienced improvement in several areas. As you know, delinquencies were down 4%, TDR was down 7%, NPL was down 13% and charge-offs were flat, so we feel good there. And as well, as you mentioned, David did our shared national credits were included. And just to comment on the shared national credits, we weren't agent on any of those credits, by the way.

If I speak specifically to our classified loan category, I'm going to categorize what happened this quarter as follows, which is really over half of the increase came from five energy credits that moved into this category. But since quarter-end, one of these credits has been totally resolved, and the other three credits are to a large energy services customer that stays with us for well over 50 years. And they have the proven ability to perform through the cycle.

So, for energy, in general, I'll make a comment that our book right now is only 13% oilfield services. And we also have gone through and stressed our price deck, on which we both lend as well as service our accounts down to $39.20, and that's against today's price. The last I looked this morning, it was about $54 a barrel, give or take. So, based on all of this, we've done a lot of work, we believe our energy losses will stay somewhere within a really manageable range of about $30 million to $50 million over the next three years.

In addition to energy, we also had some asset-based loans that we moved to classified this quarter, with all of them currently being well within their asset values. So, as such, we anticipate minimal to no loss on those credits. And lastly, we also reviewed the top 80% of credits that moved to our classified category this quarter. And again, based on this, we're comfortable with both our loss range of 40 to 50 basis points for this year and 40 to 65 basis points over the next year based on a falling economy.

So, I'd summarize by saying we don't see what happened this quarter as being a systemic issue. We are, however, coming off the period of historically low numbers. And as such, we believe that some increase was to be expected.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp. A

I'll add, Barb, the 40 to 65 basis points loss rate was over the next three years.

Barbara I. Godin
Senior Executive Vice President, Deputy Chief Risk Officer and Chief Credit Officer, Regions Financial Corp. A

Three years. I'm sorry [indiscernible] (00:57:29).

Christopher Marinac
Analyst, Janney Montgomery Scott LLC Q

Okay. Great. That's helpful background. And again, with the inclusion of the additional categories, does that imply that restaurants and ABL and others had deterioration in the quarter, or again, you're just giving more transparency to those in general?

Barbara I. Godin
Senior Executive Vice President, Deputy Chief Risk Officer and Chief Credit Officer, Regions Financial Corp. A

There's some marginal deterioration, but we're really are just trying to get much more transparency.

Christopher Marinac
Analyst, Janney Montgomery Scott LLC Q

Okay. Great. Thank you, Barb. Appreciate it.

Barbara I. Godin
Senior Executive Vice President, Deputy Chief Risk Officer and Chief Credit Officer, Regions Financial Corp.

A

Yes.

Operator: Your final question comes from Stephen Scouten of Sandler O'Neill.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Morning, Stephen.

Stephen Kendall Scouten
Analyst, Sandler O'Neill & Partners LP

Q

Yeah. Good morning. Thanks. I just had a follow-up question, maybe to Betsy's earlier question around the RoTCE guidance, and kind of just maybe more specifically, why that would move down. I just remember from your Investor Day, you guys had a pretty – not negative, but maybe muted view on the economy, kind of where GDP was going to go. Fed Funds reverting to a zero-range policy and even a 10-year, I think, around 1.50%. So, granted a lot of what we're seeing today is kind of what you guys predicted, so I'm wondering what specifically is driving the change in expectations relative to what you said then?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. I think, Stephen, our expectation in the 10-year was closer to 3% than the 1.50% at the time we gave that out. So, there are two things that drive returns, the numerator and denominator. And that denominator impact on lower rates is pretty tough. When you have a falling rate environment, clearly, the fair value of the investment portfolio, and therefore, book value increases. And that's the same thing in all the derivatives that we've added. The fair value of those have obviously increased, putting pressure on the denominator. So, that's more meaningful than you might think when you go through the calculation.

From a net income standpoint, clearly, we had rate expectations and margin guidance that had been as high as 3.70% down to low-3.40%. That's where we are. And so, 18% to 21%, predicated on being at the low end of the range. So, I think if you look at our industry and you think of just good core commercial banking, a 20% return on capital can get you – you can get there when you have a rising rate environment margins are continuing to expand.

We don't have that. We have low rates, a relatively flat yield curve, and at least the market's saying, no real expectations for rates to change over the next couple of years. So, it's really hammering out net income growth and return through making good investments to grow NIR and watching expenses, keeping your tabs on credit quality, and that's what we're doing. But it's – you can't get to those type of returns in this environment, if it persists.

Stephen Kendall Scouten
Analyst, Sandler O'Neill & Partners LP

Q

Got it. Very helpful. Thanks, David.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Okay.

John M. Turner, Jr.

President, Chief Executive Officer & Director, Regions Financial Corp.

Okay. Since we have no further questions, thank you all for your interest today. Appreciate it very much. Have a good day.

Operator: This concludes today's conference call. You may now disconnect.